UNITY BANCORP INC /NJ/
Form 10-Q
November 09, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2011

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM ____ TO ____.

Commission file number 1-12431

Unity Bancorp, Inc.
(Exact Name of Registrant as Specified in Its Charter)

New Jersey	22-3282551
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
64 Old Highway 22, Clinton, NJ	08809
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code (908) 730-7630

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934, as amended, during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:
Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a nonaccelerated filer (as defined in Exchange Act Rule 12b-2):
Large accelerated filer o Accelerated filer o Nonaccelerated filer o Smaller reporting company x

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act:
Yes o No x

The number of shares outstanding of each of the registrant's classes of common equity stock, as of November 1, 2011
common stock, no par value: 7,412,731 shares outstanding

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PART I - CONSOLIDATED FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.
Consolidated Balance Sheets
At September 30, 2011, December 31, 2010 and September 30, 2010
(Unaudited)

(In thousands)	September 30, 2011	December 31, 2010	September 30, 2010
ASSETS			
Cash and due from banks	$ 15,965	$ 17,637	$ 16,928
Federal funds sold and interest-bearing deposits	74,125	26,289	30,379
Cash and cash equivalents	90,090	43,926	47,307
Securities:			
Securities available for sale, at fair value	88,083	107,131	111,777
Securities held to maturity (fair value of $13,782, $21,351, and $23,745, respectively)	12,669	21,111	23,043
Total securities	100,752	128,242	134,820
Loans:			
SBA loans held for sale	9,284	10,397	19,021
SBA loans held to maturity	66,363	75,741	72,197
SBA 504 loans	55,520	64,276	65,075
Commercial loans	284,046	281,205	284,875
Residential mortgage loans	136,942	128,400	131,479
Consumer loans	51,478	55,917	56,869
Total loans	603,633	615,936	629,516
Allowance for loan losses	(16,447)	(14,364)	(14,163)
Net loans	587,186	601,572	615,353
Premises and equipment, net	10,648	10,967	11,137
Bank owned life insurance (BOLI)	9,033	8,812	8,732
Deferred tax assets	6,889	7,550	7,168
Federal Home Loan Bank stock, at cost	4,088	4,206	4,656
Accrued interest receivable	3,519	3,791	3,750
Other real estate owned (OREO)	3,555	2,346	5,773
Prepaid FDIC insurance	2,653	3,266	3,545
Goodwill and other intangibles	1,533	1,544	1,548
Other assets	706	2,188	2,596
Total Assets	$ 820,652	$ 818,410	$ 846,385
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities:			
Deposits:			
Noninterest-bearing demand deposits	$ 93,706	$ 91,272	$ 87,837
Interest-bearing demand deposits	100,807	105,530	100,350

Savings deposits		296,571		277,394		292,372
Time deposits, under $100,000		105,840		119,478		124,851
Time deposits, $100,000 and over		57,247		61,114		64,748
Total deposits		654,171		654,788		670,158
Borrowed funds		75,000		75,000		86,044
Subordinated debentures		15,465		15,465		15,465
Accrued interest payable		533		556		618
Accrued expenses and other liabilities		2,347		2,516		3,370
Total liabilities		747,516		748,325		775,655
Commitments and contingencies		-		-		-
Shareholders' equity:						
Cumulative perpetual preferred stock		19,409		19,019		18,894
Common stock		53,663		55,884		55,798
Accumulated deficit		(1,056)		(772)		(473)
Treasury stock at cost		-		(4,169)		(4,169)
Accumulated other comprehensive income		1,120		123		680
Total Shareholders' Equity		73,136		70,085		70,730
Total Liabilities and Shareholders' Equity	$	820,652	$	818,410	$	846,385
Preferred shares		21		21		21
Issued common shares		7,413		7,636		7,632
Outstanding common shares		7,413		7,211		7,207

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp
Consolidated Statements of Income
For the three and nine months ended September 30, 2011 and 2010
(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
(In thousands, except per share amounts)	2011	2010	2011	2010
INTEREST INCOME				
Federal funds sold and interest-bearing deposits	$ 6	$ 21	$26	$76
Federal Home Loan Bank stock	46	65	147	148
Securities:				
Available for sale	804	1,071	2,558	3,405
Held to maturity	157	270	625	858
Total securities	961	1,341	3,183	4,263
Loans:				
SBA loans	1,243	1,225	3,671	3,977
SBA 504 loans	838	1,093	2,626	3,270
Commercial loans	4,417	4,454	13,304	13,546
Residential mortgage loans	1,825	1,808	5,502	5,729
Consumer loans	616	719	1,931	2,174
Total loans	8,939	9,299	27,034	28,696
Total interest income	9,952	10,726	30,390	33,183
INTEREST EXPENSE				
Interest-bearing demand deposits	137	148	420	593
Savings deposits	536	639	1,701	2,268
Time deposits	979	1,450	3,119	4,952
Borrowed funds and subordinated debentures	947	1,077	2,851	3,232
Total interest expense	2,599	3,314	8,091	11,045
Net interest income	7,353	7,412	22,299	22,138
Provision for loan losses	1,400	1,500	5,650	4,500
Net interest income after provision for loan losses	5,953	5,912	16,649	17,638
NONINTEREST INCOME				
Branch fee income	374	359	1,054	1,051
Service and loan fee income	213	251	840	705
Gain on sale of SBA loans held for sale, net	338	269	848	416
Gain on sale of mortgage loans	250	247	506	504
Bank owned life insurance (BOLI)	74	79	221	230
Net security gains	266	35	353	42
Other income	139	220	534	592
Total noninterest income	1,654	1,460	4,356	3,540
NONINTEREST EXPENSE				
Compensation and benefits	2,944	2,960	8,881	8,781
Occupancy	615	624	2,161	1,910
Processing and communications	549	529	1,593	1,609
Furniture and equipment	384	440	1,178	1,311
Professional services	206	229	599	657
Loan collection costs	235	272	660	698

OREO expense	491	482	936	669
Deposit insurance	60	333	661	983
Advertising	187	130	510	478
Other expenses	430	405	1,328	1,288
Total noninterest expense	6,101	6,404	18,507	18,384
Income before provision for income taxes	1,506	968	2,498	2,794
Provision for income taxes	420	242	548	639
Net income	1,086	726	1,950	2,155
Preferred stock dividends & discount accretion	386	385	1,164	1,136
Income available to common shareholders	$ 700	$ 341	$786	$1,019
Net income per common share - Basic	$ 0.09	$ 0.05	$0.11	$0.14
- Diluted	$ 0.09	$ 0.05	$0.10	$0.14
Weighted average common shares outstanding - Basic	7,413	7,176	7,301	7,161
- Diluted	7,781	7,467	7,719	7,417

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp
Consolidated Statements of Comprehensive Income
For the three and nine months ended September 30, 2011 and 2010
(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
(In thousands)	2011	2010	2011	2010
Net income	$ 1,086	$ 726	$1,950	$2,155
Other comprehensive income, net of tax:				
Unrealized gains on securities:				
Unrealized holding gains arising during the period	143	406	1,060	1,134
Less: Reclassification adjustment for gains included in net income	210	23	313	85
Total unrealized gains (losses) on securities	(67)	383	747	1,049
Unrealized gains on cash flow hedge derivatives:				
Unrealized holding gains arising during the period	91	42	250	92
Total other comprehensive income	24	425	997	1,141
Total comprehensive income	$ 1,110	$ 1,151	$2,947	$3,296

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Consolidated Statements of Changes in Shareholders' Equity
For the nine months ended September 30, 2011 and 2010
(Unaudited)

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2009	$ 18,533	7,144	$ 55,454	$ (1,492)	$ (4,169)	$ (461)	$ 67,865
Comprehensive income:							
Net income				2,155			2,155
Other comprehensive income						1,141	1,141
Total comprehensive income							3,296
Accretion of discount on preferred stock	361			(361)			-
Dividends on preferred stock (5% annually)				(775)			(775)
Common stock issued and related tax effects (a)		63	344				344
Balance, September 30, 2010	$ 18,894	7,207	$ 55,798	$ (473)	$ (4,169)	$ 680	$ 70,730

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2010	$ 19,019	7,211	$ 55,884	$ (772)	$ (4,169)	$ 123	$ 70,085
Comprehensive income:							
Net income				1,950			1,950
Other comprehensive income						997	997
Total comprehensive income							2,947
Accretion of discount on preferred stock	390			(390)			-
Dividends on preferred stock (5% annually)				(776)			(776)
Retire Treasury stock			(3,101)	(1,068)	4,169	-	

Common stock issued and related tax effects (a)		202	880				880
Balance, September 30, 2011	$ 19,409	7,413	$ 53,663	$ (1,056)	$ -	$ 1,120	$ 73,136

(a) Includes the issuance of common stock under employee benefit plans, which includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Consolidated Statements of Cash Flows
For the nine months ended September 30, 2011 and 2010
(Unaudited)

	For the nine months ended September 30,	
(In thousands)	2011	2010
OPERATING ACTIVITIES		
Net income	$ 1,950	$ 2,155
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	5,650	4,500
Net amortization of purchase premiums and discounts on securities	378	644
Depreciation and amortization	560	941
Deferred income tax benefit	(4)	(630)
Net security gains	(353)	(42)
Stock compensation expense	145	219
Loss on sale of other real estate owned	198	368
Gain on sale of SBA loans held for sale, net	(848)	(416)
Gain on sale of mortgage loans	(506)	(504)
Origination of mortgage loans held for sale	(29,029)	(26,182)
Origination of SBA loans held for sale	(9,977)	(2,679)
Proceeds from sale of mortgage loans held for sale, net	29,535	26,686
Proceeds from sale of SBA loans held for sale, net	11,938	4,250
Loss on sale or disposal of premises and equipment	199	9
Net change in other assets and liabilities	3,774	1,899
Net cash provided by operating activities	13,610	11,218
INVESTING ACTIVITIES:		
Purchases of securities held to maturity	-	(2,330)
Purchases of securities available for sale	(30,264)	(27,704)
Maturities and principal payments on securities held to maturity	6,197	5,517
Maturities and principal payments on securities available for sale	27,485	46,475
Proceeds from sale of securities held to maturity	2,168	1,893
Proceeds from sale of securities available for sale	23,123	11,507
Proceeds from redemption of Federal Home Loan Bank stock	117	21
Proceeds from sale of other real estate owned	1,526	2,298
Net decrease in loans	3,647	15,202
Purchase of bank owned life insurance	-	(2,500)
Proceeds from sale or disposal of premises and equipment	225	35
Purchases of premises and equipment	(725)	(283)
Net cash provided by investing activities	33,499	50,131
FINANCING ACTIVITIES:		
Net decrease in deposits	(617)	(88,081)

Proceeds from new borrowings			-	1,044
Proceeds from the exercise of stock options			446	134
Cash dividends paid on preferred stock			(774)	(774)
Net cash used in financing activities			(945)	(87,677)
Increase (decrease) in cash and cash equivalents			46,164	(26,328)
Cash and cash equivalents, beginning of period			43,926	73,635
Cash and cash equivalents, end of period	$		90,090	$ 47,307
SUPPLEMENTAL DISCLOSURES:				
Cash:				
Interest paid	$	8,114		$ 11,137
Income taxes paid		356		1,204
Noncash investing activities:				
Transfer of SBA loans held for sale to held to maturity		-		1,230
Transfer of loans to other real estate owned		4,047		6,909

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

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Unity Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)
September 30, 2011

NOTE 1. Significant Accounting Policies

The accompanying Consolidated Financial Statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank's investment portfolio. All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation, with no impact on current earnings. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses during the reporting periods. Actual results could differ from those estimates. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the consolidated financial statements included in this Quarterly Report on Form 10-Q were issued.

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses, the valuation of deferred income tax assets and the fair value of financial instruments. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC"). The results of operations for the nine months ended September 30, 2011 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

Stock Transactions

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. In addition, restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time.

Stock Option Plans

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of September 30, 2011, 1,720,529 shares have been reserved for issuance upon the exercise of options, 582,647 option grants are outstanding, and 956,557 option grants have been exercised, forfeited or expired, leaving 181,325 shares available for grant.

The Company granted 67,000 options in 2011 as compared to no options in 2010. The fair value of the options granted in 2011 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2011	2010
Number of options granted	67,000	-
Weighted average exercise price	$6.66	$-
Weighted average fair value of options	$3.20	$-
Expected life (years)	4.62	-
Expected volatility	57.69 %	- %
Risk-free interest rate	1.28 %	- %
Dividend yield	0.00 %	- %

The expected life of the options was estimated based on historical employee behavior and represents the period of time that options granted are expected to be outstanding. Expected volatility of the Company's stock price was based on the historical volatility over the period commensurate with the expected life of the options. The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the date of grant. The expected dividend yield is the projected annual yield based on the grant date stock price.

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options totaled $40 thousand and $52 thousand for the three months ended September 30, 2011 and 2010, respectively. The related income tax benefit was approximately $16 thousand and $21 thousand for the three months ended September 30, 2011 and 2010, respectively. Compensation expense related to stock options totaled $85 thousand and $135 thousand for the nine months ended September 30, 2011 and 2010, respectively. The related income tax benefit was approximately $32 thousand and $54 thousand for the nine months ended September 30, 2011 and 2010, respectively. As of September 30, 2011, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately $238 thousand. That cost is expected to be recognized over a weighted average period of 2.3 years.

Transactions under the Company's stock option plans for the nine months ended September 30, 2011 are summarized in the following table:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2010	775,468	$ 5.90	3.9	$1,049,184
Options granted	67,000	6.66		
Options exercised	(233,105)	3.39		
Options forfeited	(3,449)	6.62		
Options expired	(23,267)	9.62		
Outstanding at September 30, 2011	582,647	$ 6.84	5.1	$584,626
Exercisable at September 30, 2011	447,482	$ 7.30	4.0	$401,639

The following table summarizes information about stock options outstanding at September 30, 2011:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
$ 0.00 - 4.00	125,416	7.6	$3.88	65,586	$3.85
4.01 - 8.00	278,973	5.1	5.97	203,638	5.81
8.01 - 12.00	121,617	2.5	9.22	121,617	9.22
12.01 - 16.00	56,641	5.2	12.54	56,641	12.54
Total	582,647	5.1	$6.84	447,482	$7.30

The following table presents information about options exercised during the three and nine months ended September 30, 2011 and 2010:

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Number of options exercised	738	50,929	233,105	76,671
Total intrinsic value of options exercised	$2,294	$ 115,156	$ 753,440	$ 130,972
Cash received from options exercised	2,610	47,048	445,515	78,743
Tax deduction realized from options exercised	569	45,977	298,494	52,276

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options.

Restricted Stock Awards

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value at the time of grant and amortized into salary expense on a straight line basis over the vesting period. As of September 30, 2011, 221,551 shares of restricted stock were reserved for issuance, of which 91,162 shares are available for grant.

Restricted stock awards granted during the nine months ended September 30, 2011 and 2010 include:

	2011	2010
Shares	22,500	-
Average Grant Date Fair Value	$6.66	$-

Compensation expense related to the restricted stock awards totaled $29 thousand and $27 thousand for the three months ended September 30, 2011 and 2010, respectively. Compensation expense related to the restricted stock awards totaled $60 thousand and $84 thousand for the nine months ended September 30, 2011 and 2010, respectively.

As of September 30, 2011, there was approximately $250 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 3.1 years.

The following table summarizes nonvested restricted stock activity for the nine months ended September 30, 2011:

	Shares	Average Grant Date Fair Value
Nonvested restricted stock at December 31, 2010	43,367	$ 5.83
Granted	22,500	6.66
Vested	(10,182)	8.92
Forfeited	(1,326)	8.72
Nonvested restricted stock at September 30, 2011	54,359	$ 5.52

Income Taxes

The Company follows FASB ASC Topic 740, "Income Taxes," which prescribes a threshold for the financial statement recognition of income taxes and provides criteria for the measurement of tax positions taken or expected to be taken in a tax return. ASC 740 also includes guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition of income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to the income tax provision.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that ultimately would be sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. The evaluation of a tax position taken is considered by itself and not offset or aggregated with other positions. Tax positions that meet the more likely than not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits are recognized in income tax expense on the income statement.

Derivative Instruments and Hedging Activities

The Company uses derivative instruments, such as interest rate swaps, to manage interest rate risk. The Company recognizes all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income. As of September 30, 2011, all of the Company's derivative instruments qualified as hedging instruments.

For those derivative instruments that are designated and qualify as hedging instruments, the Company must designate the hedging instrument, based on the exposure being hedged, as a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation. The Company does not have any fair value hedges or hedges of foreign operations.

The Company formally documents the relationship between the hedging instruments and hedged item, as well as the risk management objective and strategy before undertaking a hedge. To qualify for hedge accounting, the derivatives and hedged items must be designated as a hedge. For hedging relationships in which effectiveness is measured, the Company formally assesses, both at inception and on an ongoing basis, if the derivatives are highly effective in offsetting changes in fair values or cash flows of the hedged item. If it is determined that the derivative instrument is not highly effective as a hedge, hedge accounting is discontinued.

For derivatives that are designated as cash flow hedges, the effective portion of the gain or loss on derivatives is reported as a component of other comprehensive income or loss and subsequently reclassified in interest income in the same period during which the hedged transaction affects earnings. As a result, the change in fair value of any ineffective portion of the hedging derivative is recognized immediately in earnings.

The Company will discontinue hedge accounting when it is determined that the derivative is no longer qualifying as an effective hedge; the derivative expires or is sold, terminated or exercised; or the derivative is de-designated as a fair value or cash flow hedge or it is no longer probable that the forecasted transaction will occur by the end of the originally specified time period. If the Company determines that the derivative no longer qualifies as a cash flow or fair value hedge and therefore hedge accounting is discontinued, the derivative will continue to be recorded on the balance sheet at its fair value with changes in fair value included in current earnings.

Loans Held To Maturity and Loans Held For Sale

Loans held to maturity are stated at the unpaid principal balance, net of unearned discounts and net of deferred loan origination fees and costs. Loan origination fees, net of direct loan origination costs, are deferred and are recognized over the estimated life of the related loans as an adjustment to the loan yield utilizing the level yield method.

Interest is credited to operations primarily based upon the principal amount outstanding. When management believes there is sufficient doubt as to the ultimate ability to collect interest on a loan, interest accruals are discontinued and all past due interest, previously recognized as income, is reversed and charged against current period earnings. Payments received on nonaccrual loans are applied as principal. Loans are returned to an accrual status when the ability to collect is reasonably assured and when the loan is brought current as to principal and interest.

Loans are reported as past due when either interest or principal is unpaid in the following circumstances: fixed payment loans when the borrower is in arrears for two or more monthly payments; open end credit for two or more billing cycles; and single payment notes if interest or principal remains unpaid for 30 days or more.

Loans are charged off when collection is sufficiently questionable and when the Company can no longer justify maintaining the loan as an asset on the balance sheet. Loans qualify for charge-off when, after thorough analysis, all possible sources of repayment are insufficient. These include: 1) potential future cash flows, 2) value of collateral, and/or 3) strength of co-makers and guarantors. All unsecured loans are charged off upon the establishment of the loan's nonaccrual status. Additionally, all loans classified as a loss or that portion of the loan classified as a loss are charged off. All loan charge-offs are approved by the Board of Directors.

Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income.

The Company evaluates its loans for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Company has defined impaired loans to be all troubled debt restructurings and nonperforming loans. Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for other loans. Troubled debt restructurings ("TDRs") occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider, unless it results in a delay in payment that is insignificant. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. Interest income on accruing TDRs is credited to operations primarily based upon the principal amount outstanding, as stated in the paragraphs above. Impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. Impairment can also be measured based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge or credit to the provision for loan losses.

Loans held for sale are SBA loans and are reflected at the lower of aggregate cost or market value. The net amount of loan origination fees on loans sold is included in the carrying value and in the gain or loss on the sale.

The Company originates loans to customers under an SBA program that generally provides for SBA guarantees of up to 90 percent of each loan. The Company generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. During late 2008, the Company withdrew from SBA lending outside of its primary trade area, but continues to offer SBA loan products as an additional credit product within its primary trade area. If sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income.

Serviced loans sold to others are not included in the accompanying consolidated balance sheets. Income and fees collected for loan servicing are credited to noninterest income when earned, net of amortization on the related servicing assets.

For additional information see the section titled "Loan Portfolio" under Item 2. Management's Discussion and Analysis.